TOPIC 1

Financial Statements

The four financial statements discussed in this topic are required by the Securities and Exchange Commission (SEC) for all publicly traded companies and are a useful tool for presenting a basic financial picture of any company. The four required financial statements include the income statement, the statement of changes in equity, the balance sheet, and the statement of cash flows.

LOS §1.A.1.g

The four financial statements are integrally related. The balance sheet is connected to the income statement (net income) through the change in retained earnings shown in the statement of changes in shareholders' equity. The balance sheet change in cash and other changes in financial position are presented in the statement of cash flow. Changes in capital received in the balance sheet are shown in the statement of changes in shareholders' equity.

LOS §1.A.1.e

The way in which various financial transactions affect the elements of each of the financial statements and the proper classification of the various financial transactions is covered in Topic 2: Recognition, Measurement, Valuation, and Disclosure.

The financial statements shown in this topic are all for a fictitious organization, Robin Manufacturing Company, for a given year, and linkages between the various statements are illustrated with notes and by the amounts themselves. The footnotes to financial statements, which present required disclosures, are also covered.

Most entities provide prior years' financial statement information next to the current year's information for comparison. For example, income and cash flow statements usually show the results of three consecutive years, which allows analysts to compare past performance to present performance and make a determination of future success.

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READ the Learning Outcome Statements (LOS) for this topic as found in Appendix A and then study the concepts and calculations presented here to be sure you understand the content you could be tested on in the CMA exam.

This topic ends with a discussion of the needs of external users and how financial statements satisfy some of those needs.

Income Statement

LOS §1.A.1.b

The income statement, commonly called a profit and loss (P&L) statement, measures the earnings of an entity's operations over a given period of time, such as a quarter or a year. The income statement is used to measure profitability, creditworthiness, and investment value of an entity, and along with the other statements, it helps assess the amounts, timing, and uncertainty of future cash flows.

Income and Other Comprehensive Income

The financial statement elements reported on the income statement are revenues, expenses, gains, and losses. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 220, *Comprehensive Income* (formerly SFAS No. 130), requires firms to report certain unrealized gains and losses outside of net income as components of other comprehensive income. **Comprehensive income** is the sum of net income plus (or minus) the items of other comprehensive income.

Firms have the option of presenting the calculation of comprehensive income either as part of an income statement (appended at the end) or as a separate statement of comprenhensive income. Comprehensive income can no longer be presented as a part of the statement of shareholders' equity.

Format of Financial Information

The two most common formats are single-step income statements and multiple-step income statements.

Single-Step Income Statement

A single-step income statement subtracts total expenses and losses from total revenues and gains in a single step. No attempt is made to categorize expenses and revenues or to arrive at interim subtotals. However, despite the inherent simplicity of the single-step income statement, the multiple-step income statement is currently more popular.

Figure 1A-1 shows a single-step income statement for Robin Manufacturing Company, Year 1.

Figure 1A-1 Single-Step Income Statement

LOS §1.A.1.h

Robin Manufacturing Company Income Statement for the Year Ended December 31, Year 1	
Revenues	
Net sales	$2,734,620
Dividend revenue	90,620
Rental revenue	67,077
Total revenues	2,892,317
Expenses	
Cost of goods sold	1,823,938
Selling expenses	416,786
Administrative expenses	322,709
Interest expense	115,975
Income tax expense	61,579
Total expenses	2,740,987
Net income	$151,330
Earnings per common share	$1.89

→ **To** statement of changes in equity section **(Figure 1A-4)**

Multiple-Step Income Statement

LOS §1.A.1.c

The multiple-step income statement separates information into operating and nonoperating categories. The sections in the statement that do not relate to operating cash flows are called other revenues and gains and other expenses and losses. These categories could include gains and losses from the sale of equipment, interest revenue and expense, or dividends received.

The multiple-step income statement has subcategories, such as cost of goods sold (COGS); operating (selling and administrative) expenses; and other revenues, expenses, gains, and losses. These subcategories allow users to compare a company's results over time or with those of a competitor to determine the efficiency with which the entity's scarce resources are used. Such comparisons are especially valuable when several years' income statements are compared.

The multiple-step income statement often reports subtotals for gross profit and income from operations, which are useful for financial statement analysis purposes. For example, gross profit can be used to compare how competitive pressures have affected profit margins.

Figure 1A-2 shows a multiple-step income statement.

Figure 1A-2 Multiple-Step Income Statement

LOS §1.A.1.h

Robin Manufacturing Company **Income Statement for the Year Ended December 31, Year 1 (Y1)**			
Sales Revenue			
Sales			$2,808,835
Less: Sales discounts		$22,302	
Less: Sales returns and allowances		51,913	74,215
Net sales revenue			2,734,620
Cost of Goods Sold			
Merchandise inventory, Jan. 1, Y1		424,321	
Purchases	$1,830,518		
Less: Purchase discounts	17,728		
Net purchases	1,812,790		
Freight and transportation—in	37,363	1,850,153	
Total merchandise available for sale		2,274,474	
Less: Merchandise inventory, Dec. 31, Y1		450,536	
Cost of goods sold			$1,823,938
Gross profit on sales			910,682
Operating Expenses			
Selling expenses			
Sales salaries and commissions	186,432		
Sales office salaries	54,464		
Travel and entertainment	45,025		
Advertising expense	35,250		
Freight and transportation—out	37,912		
Shipping supplies and expense	22,735		
Postage and stationery	15,445		
Depreciation of sales equipment	8,285		
Telephone and Internet expense	11,238	416,786	
Administrative expenses			
Officers' salaries	171,120		
Office salaries	56,304		
Legal and professional services	21,823		
Utilities expense	21,413		
Insurance expense	15,667		
Building depreciation	16,614		
Office equipment depreciation	14,720		
Stationery, supplies, and postage	2,645		
Miscellaneous office expenses	2,403	322,709	739,495
Income from operations			171,187
Other Revenues and Gains			
Dividend revenue		90,620	
Rental revenue		67,077	157,697
			328,884
Other Expenses and Losses			
Interest on bonds and notes			115,975
Income before income tax			212,909
Income tax			61,579
Net income for the year			$151,330
Earnings per common share			$1.89

→ **To** statement of change in equity **(Figure 1A-4)**

Additional Income Statement Presentation Items

Occasionally, companies will experience an event that requires separate reporting below income from continuing operations. Additional items that may be located at the end of the income statement include discontinued operations and extraordinary items.

- **Discontinued operations.** When an entity disposes of a business component that has clearly distinguishable operations and cash flows the item is recorded in a separate section of the income statement after continuing operations and before extraordinary items. Discontinued operations are shown net of tax.
- **Extraordinary items.** Material items that are both unusual in nature and infrequent in occurrence also require a separate section in the income statement and are shown net of tax.

Figure 1A-3 shows how net income is determined when these items are included.

Figure 1A-3 Multistep Income Statement with Additional Income Statement Items

Net sales
– Cost of goods sold
Gross profit on sales
– Operating expenses
Operating income
+/– Other gains and losses
Earnings before tax
– Tax expense
Income from continuing operations
+/– Discontinued operations
+/– Extraordinary items
+/– Changes in accounting principle
Net income

Statements of Change in Equity

LOS §1.A.1.b

When a balance sheet is issued, the FASB requires disclosure of the changes in each separate shareholder's equity account. This requirement satisfies the FASB's suggestion that complete financial statements should include investments by and distributions to owners during the period. The required statements of change in equity is intended to help external users assess how changes in the company's financial structure may affect its financial flexibility.

Major Components and Classifications

LOS §1.A.1.c

Shareholders' equity includes several components: capital stock (par value of preferred and common shares), additional paid-in capital, retained earnings, and

accumulated other comprehensive income. Capital stock is the par value (or face value) for the shares, and additional paid-in capital is the amount paid for the shares in excess of par. Thus, these two categories combine to form contributed capital, also called paid-in capital. Retained earnings can be subdivided into general earnings retained for company use and appropriated earnings set aside for some purpose.

Format of Financial Information

The statement of changes in equity usually lists information in the following order:

- Beginning balance for the period
- Additions
- Deductions
- Ending balance for the period

Figure 1A-4 shows a sample statement of changes in equity. This example shows the statement listed in a columnar format for a company with only common stock outstanding.

Figure 1A-4 Statement of Changes in Equity

LOS §1.A.1.h

Robin Manufacturing Company
Schedule of Changes in Shareholders' Equity
for Year Ended December 31, Year 1 (Y1)

	Common Stock, $1 Par	Additional Paid-In Capital	Retained Earnings	Total
Balance, Jan. 1, Y1	$24,680	$345,520	$90,251	$460,451
Net income			151,330	151,330
Cash dividends paid			(33,330)	(33,330)
Common stock issued	1,000	14,800		15,800
Balance, Dec. 31, Y1	$25,680	$360,320	$208,251	$594,251

From income statement (Figures 1A-1 and 1A-2) → Net income

Total → **To** balance sheet (Figure 1A-6)

Balance Sheet

LOS §1.A.1.b

The balance sheet (sometimes called a statement of financial position) is an essential tool in assessing the amounts, timing, and uncertainty of prospective cash flows. It is referred to as the balance sheet because of the balance expressed by the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders's Equity}$$

Alternatively, the accounting equation can tell us that equity equals assets less liabilities, which is also known as net assets. The balance sheet provides a snapshot of the company's assets and the claims on those assets at a specific point in time.

While the balance sheet does not claim to show the value of the entity, it should allow external users to make their own estimates of the entity's value when used in conjunction with the other financial statements and other relevant information.

The balance sheet helps users evaluate the capital structure of the entity and assess the entity's liquidity, solvency, financial flexibility, and operating capability.

The balance sheet is also essential in understanding the income statement because revenues and expenses reflect changes in assets and liabilities, so an analyst must evaluate both statements together.

Major Components and Classifications

LOS §1.A.1.c

The balance sheet is divided into three sections: assets, liabilities, and shareholders' equity. These classifications are designed to group similar items together so they can be analyzed more easily. Assets are listed with the most liquid items first and the least liquid last. Liabilities are listed in the order in which they become due. In the case of equity, the items that have most claim to the equity are listed before items with less claim. Figure 1A-5 summarizes the general subdivisions of each category.

Figure 1A-5 Balance Sheet Components

Assets	Current assets (cash, accounts receivable [A/R], inventory, etc.) Long-term investments Property, plant, and equipment (PP&E)	Intangible assets (patents, goodwill, etc.) Other assets
Liabilities	Current liabilities (accounts payable [A/P], interest payable, current portion of long-term debt, etc.)	Long-term liabilities (bonds, mortgages, etc.) Other liabilities
Shareholders' equity	Capital stock Treasury stock (contra equity) Additional paid-in capital	Accumulated other comprehensive income Retained earnings

The components of assets, liabilities, and equity are more thoroughly discussed in Topic 2 of this section.

Format of Financial Information

The two most common formats for the balance sheet are the account form and the report form. All styles of balance sheets break down the assets, liabilities, and shareholders' equity into the categories listed in Figure 1A-5 (current assets, etc.). The account form lists assets on the left side and liabilities and shareholders' equity

on the right side. The report form, shown in Figure 1A-6, lists assets at the top and liabilities and shareholders' equity at the bottom. Outside the United States, other balance sheet formats are used, such as the financial position form, which deducts current liabilities from current assets to show working capital.

LOS §1.A.1.h

Figure 1A-6 Balance Sheet

Robin Manufacturing Company Balance Sheet December 31, Year 1	
Assets	
Current assets:	
Cash and short-term investments	$24,628
Trade receivables, net of $30K allowance	552,249
Other receivables	18,941
Note receivable—related party	80,532
Inventory	252,567
Prepaid insurance	7,500
Total current assets	936,417
Fixed assets:	
Property and equipment	209,330
Less: Accumulated depreciation	(75,332)
Net fixed assets	133,998
Total assets	$1,070,415
Liabilities and Equity	
Current liabilities	
Accounts payable	$175,321
Accrued expenses	2,500
Current portion of long-term debt	36,000
Line of credit	145,000
Total current liabilities	358,821
Long-term debt	117,343
Total current and long-term liabilities	476,164
Shareholders' equity:	
Common stock, par	25,680
Additional paid-in capital	360,320
Retained earnings	208,251
Total shareholders' equity	594,251
Total liabilities and shareholders' equity	$1,070,415

From statement of change in equity (Figure 1A-4)

In Figure 1A-6, the assets and liabilities are also categorized by their levels of financial flexibility. For example, current assets are shown separately from fixed assets.

Statement of Cash Flows

LOS §1.A.1.b

Cash is a company's most liquid resource, and therefore it affects liquidity, operating capability, and financial flexibility. FASB ASC Topic 230, *Statement of Cash Flows* (formerly SFAS No. 95), says that a statement of cash flows "must report on a company's cash inflows, cash outflows, and net change in cash from its operating, financing, and investing activities during the accounting period, in a manner that reconciles the beginning and ending cash balances." The statement helps interested parties determine if an entity needs external financing or if it is generating positive cash flows to meet its obligations and pay dividends. Keep in mind that a company could have high income but still have negative cash flow.

Components and Classifications

LOS §1.A.1.c

Cash receipts and cash payments are classified in the statement of cash flows as related to operating, investing, or financing activities.

Operating Activities

Cash flows from operating activities are those related to the normal course of business. Any transaction that does not qualify as an investing or financing activity is included in the operating activity section. Examples of cash inflows include cash receipts from sales of any kind, collection of A/R, collection of interest on loans, and receipts of dividends. Cash outflows include cash paid to employees, suppliers, and the Internal Revenue Service (IRS) and to lenders for interest.

Statements that are compliant with generally accepted accounting principles (GAAP) use accrual accounting, so net income includes noncash revenues (e.g., uncollected credit sales) and noncash expenses (e.g., unpaid expenses). Other items that are included in accrual accounting are depreciation, depletion, amortization, and other costs that were incurred in prior periods but are being charged to expenses in the current period. These items reduce net income but do not affect cash flows for the current period. Therefore, these items are added back when determining net cash flow from operating activities.

Examples of noncash expense and revenue items that must be added back to net income include those listed next.

- Depreciation expense and amortization of intangible assets
- Amortization of deferred costs, such as bond issue costs
- Changes in deferred income taxes
- Amortization of a premium or discount on bonds payable
- Income from an equity method investee

To determine operating cash flows, FASB ASC Topic 230, *Statement of Cash Flows*, allows entities to use either the indirect method or the direct method.

Indirect Method

The indirect method, or reconciliation method, is the most popular method of converting net income to net cash flow from operating activities. It starts with net income and then adjusts it by adding back noncash expenses and paper losses and subtracting noncash revenues and paper gains that have no effect on current period operating cash flows. Additional adjustments are made for changes in current asset and liability accounts related to operations by adding or subtracting amounts, as shown in Figure 1A-7. For example, an increase in A/R (a current asset) would be subtracted from net income to arrive at operating cash flows because it means that the amount of cash collected from customers is less than the amount of accrual revenue reported. See Figure 1A-7 for an example of the indirect method.

LOS §1.A.1.h

Figure 1A-7 Cash Flows from Operating Activities—Indirect Method

Net income
+ Noncash expenses (typically depreciation and amortization expenses)
– Gains from investing and financing activities
+ Losses from investing and financing activities
+ Decreases in current assets
– Increases in current assets
+ Increases in current liabilities
– Decreases in current liabilities
+ Amortization of discounts on bonds
– Amortization of premiums on bonds
Operating cash flow

Direct Method

In the direct method, or income statement method, net cash provided by operating activities is calculated by converting revenues and expenses from the accrual basis to the cash basis. Although the FASB encourages the use of the direct method, it is rarely used. Furthermore, if the direct method is used, the FASB requires that the reconciliation of net income to net cash flow from operating activities be disclosed in a separate schedule. Figure 1A-8 shows how a direct method statement is arranged. (The figure includes sample amounts for illustration.)

Investing Activities

Most items in the investing activities section come from changes in long-term asset accounts. Investing cash inflows result from sales of PP&E, sales of investments in another entity's debt or equity securities, or collections of the principal on loans to another entity. (Interest is included in operating cash flows.) Investing cash outflows

Figure 1A-8 Cash Flows from Operating Activities—Direct Method

Cash received from customers	$100,000
Cash paid to suppliers	(40,000)
Cash paid for interest	(5,000)
Cash paid for taxes	(10,000)
Cash paid for operating expenses	(25,000)
Cash provided by operating activities	$20,000

result from purchases of PP&E, purchases of other companies' debt or equity securities, and the granting of loans to other entities.

Financing Activities

Most items in the financing activities section come from changes in long-term liability or equity accounts. Financing cash inflows come from the sale of the entity's equity securities or issuance of debt, such as bonds or notes. Cash outflows consist of payments to stockholders for dividends and payments to reacquire capital stock or redeem a company's outstanding debt. In other words, investing activities involve the purchase or sale of fixed assets and investments in another company's securities, while financing activities involve the issuance and redemption of a company's own equity and debt securities.

Footnotes

The statement of cash flows requires footnote disclosure of any significant noncash investing and financing activities, such as the issuing of stock for fixed assets or the conversion of debt to equity. In addition, when the indirect method for cash flow from operations is used, both interest paid and income taxes paid need to be disclosed.

Example of a Statement of Cash Flows

The statement of cash flows shown in Figure 1A-9 illustrates the more commonly used indirect approach for calculating operating cash flows. Cash flows from each category (operating, investing, and financing) are separately classified and totaled. The sum of cash inflows (or outflows if negative) from these three categories equals the net increase or decrease in cash for the period. This net cash inflow (outflow) is added to (subtracted from) the cash balance at the beginning of the year to obtain the cash balance at the end of the year (highlighted in gray). Thus the cash flow statement explains the net change in the amount of cash and cash equivalents (short-term, highly liquid investments that are close to maturity) from the beginning to the ending balance sheet.

LOS §1.A.1.h

Figure 1A-9 Statement of Cash Flows—Indirect Method

Operating Activities	
Net income (From income statement (Figures 1A-1 and 1A-2))	$151,330
Adjustments to convert net income to a cash basis:	
Depreciation and amortization charges*	75,332
Decrease (increase) in accounts receivable	(31,445)
Increase (decrease) in merchandise inventory	(4,165)
Increase (decrease) in accounts payable	6,740
Increase (decrease) in accrued wages and salaries payable	4,543
Increase (decrease) in accrued income taxes payable	3,984
Increase (decrease) in deferred income taxes	(4,950)
Gain on sale of store†	(1,255)
Net cash provided by operating activities	200,114
Investing Activities	
Additions to property, buildings, and equipment	(123,730)
Proceeds from sale of store	3,980
Net cash used in investing activities	(119,750)
Financing Activities	
Increase (decrease) in notes payable	1,100
Increase (decrease) in additional paid-in capital (From statement of change in equity (Figure 1A-4))	14,800
Increase (decrease) in long-term debt	(50,500)
Increase (decrease) in common stock (From statement of change in equity (Figure 1A-4))	1,000
Cash dividends paid (From statement of change in equity (Figure 1A-4))	(33,330)
Net cash used in financing activities	(66,930)
Net increase in cash and cash equivalents	13,434
Cash and cash equivalents at beginning of year	11,194
Cash and cash equivalents at end of year (To balance sheet (Figure 1A-6))	$24,628

Note: Changes in various asset and liability accounts (e.g., increases/decreases) can be obtained by comparing two consecutive years' balance sheets.

* Depreciation and amortization charges are included in the income statement as part of administrative expenses.

† Gain on sale of store is included in the income statement as part of other revenue.

LOS §1.A.1.d

Limitations of the Financial Statements

The following items describe the limiting characteristics of financial statements.

- *Historical cost.* Most asset accounts of a nonfinancial nature are reported at historical cost. While historical cost measures are considered reliable because the amounts can be verified, they are also considered less relevant than fair value or current market value measures would be for assessing a firm's current financial position.
- *Different accounting methods.* Employing different accounting methods will yield different net incomes. Each choice of two or more accounting methods

will further change the results reported, making the task of comparing different entities very difficult, even when these methods are disclosed.

- *Omit nonobjective items of value.* Financial statements exclude valuable assets that are of financial importance but cannot be objectively expressed in numbers. For example, the value of human resources, intangibles such as brand recognition and reputation, or the value of the entity's customer base cannot be exactly or reliably estimated, so they are not included on the balance sheet. Therefore, the balance sheet does not pretend to measure the value of the company as a whole.
- *Use of estimates and judgments.* Financial statements incorporate the use of numerous estimates and professional judgments. Differences in estimates mean that the income statements for two or more entities may be difficult to compare. Common estimates include the amount of receivables allocated to an allowance for doubtful accounts and the useful life and salvage value of a piece of equipment.
- *Off–balance sheet information.* Transactions may be recorded in a way that avoids reporting liabilities and assets on the balance sheet, for example, with an operating lease. The Sarbanes-Oxley Act of 2002 (SOX) requires publicly traded firms to disclose off–balance sheet information in their filings with the SEC.
- *Noncash transactions.* The statement of cash flows omits noncash transactions, such as the exchange of stock for a property, exchanges of nonmonetary assets, conversion of preferred stock or debt to common stock, or issuing equity securities to retire a debt. Disclosure of any noncash transactions that affect assets or liabilities would be reported in a note or a supplemental schedule.

Footnotes/Disclosures to Financial Statements

LOS §1.A.1.f

Footnotes or disclosures to financial statements are used when parenthetical explanations would not suffice to describe situations particular to the entity. Typical disclosures include contingencies, contractual situations, accounting policies, and subsequent events.

Contingencies

Contingencies are material events with an uncertain outcome dependent on the occurrence or nonoccurrence of one or more future events. Contingencies can be either gain contingencies or loss contingencies. Income recognition is not given to gain contingencies; however, loss contingencies must be recognized when it is both probable that a loss has been incurred and the amount of the loss is reasonably estimable. Other material loss contingencies should be disclosed in the footnotes to the financial statements; gain contingencies may also be disclosed.

Loss contingencies result from situations such as pending litigation, warranty and premium costs, environmental liabilities, and self-insurance risks. Gain

contingencies result from pending litigation (where the outcome is favorable to the company), possible refunds of disputed tax amounts, and tax loss carryforwards.

Contractual Situations

Contractual agreements, such as pension obligations, lease contracts, and stock option plans, are required to be disclosed in the notes to financial statements. Other significant items should also be included. Contractual situations may require an entity to restrict certain funds, for example, and analysts need to understand how such provisions will affect the entity's financial flexibility.

Accounting Policies

Whenever GAAP or industry-specific regulations allow a choice between two or more accounting methods, the method selected should be disclosed. FASB ASC Topic 235, *Notes to Financial Statements* (formerly Accounting Principles Board [APB] Opinion No. 22), states that "a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements."

ASC Topic 235 notes that three types of accounting disclosures related to recognition and asset allocation should be made:

1. Selection between acceptable alternatives
2. Selection of industry-specific methods
3. Unusual or innovative applications of GAAP

Most companies prepare a separate note, "Summary of Significant Accounting Policies," in which they report on the methods used to recognize revenue, calculate depreciation, value inventory, and measure other amounts reported on the financial statements.

Subsequent Events

It may take weeks or even months to issue the annual report after the accounting period has closed, and significant business events and transactions may occur during this period. A **subsequent event** is an event occurring between the balance sheet date and the issuance date of the annual report. If the event provides additional evidence about conditions that existed as of the balance sheet date and alters the estimates used in preparing the financial statements, then the financial statements should be adjusted.

Subsequent events that provide evidence regarding conditions that did not exist on the balance sheet date should be disclosed in a note, supplemental schedule, or pro forma statement.

In addition to the disclosures mentioned already, Figure 1A-10 lists other major areas that require some form of disclosure beyond the information presented in the financial statements.

These disclosures are covered in more detail throughout the rest of this book.

Figure 1A-10 Summary of Required Footnotes/Disclosures

Category	Footnote/Disclosure
Inventories	Valuation basis (net realizable value, cost, lower of cost or market) Cost flow assumption (specific identification; average cost; first in, first out [FIFO]; last in, first out [LIFO]) Inventory classifications (purchases, raw materials, work-in-process accounts, finished goods, supplies); classified separately only if significant Product financing arrangements, if any FIFO equivalent if the company uses LIFO
Revenue	Policy on revenue recognition
Accounts receivable	Collectibility Collection policy Determination of bad debt Allowance for bad debt
PP&E	Valuation basis Depreciation expenses for the period Accumulated depreciation at the balance sheet date Depreciable asset balances by major class (either by nature or function) General description of the depreciation methods used by major class of depreciable asset
Intangibles (e.g., patents)	Description of the nature of the intangible Amount of amortization expense for the period Method and period of amortization Remaining useful life of the intangible
Bonds payable	Par value Stated and effective interest rate Call provisions Maturity date
Preferred stock	Par or stated value Changes in the number of shares authorized, issued, and outstanding for the period Dividend rate Special features of the preferred stock (convertible, cumulative, participating) Dividends in arrears
Common stock	Par or stated value Changes in the number of shares authorized, issued, and outstanding for the period Dividends declared (amount and type)
Other	Amount, nature, duration, and other significant provisions of any restrictions on retained earnings Prior period adjustments Employee plans, such as employee stock option plans (ESOPs)

LOS
§1.A.1.a

Users of Financial Statements

Financial statements are intended to aid in decision making. The most efficient companies will attract investors or will be granted credit first and will also be more likely to produce a higher return on investment. Moreover, a company becomes efficient partly through the proper allocation of its internal resources to those areas most likely to produce a profit. Financial statements are an integral part of the decision-making process for users both internal to the organization and external to it.

Internal and External Users

Internal Users

Internal users need financial statements and other sources of information for internal decision making. The information is used to plan and control operations on both a short-term and long-term basis. The quality of these decisions will have an impact on how internal resources are allocated, the profits that are realized, and, ultimately, whether the organization will survive. Internal users of financial statements include executives, managers, management accountants, and other employees including those with stock options or investments in the organization. Unlike external users, internal users may request or generate any type of information that is available in their accounting system. The potential for misuse of such information requires an organization to place internal controls on the use and access to such information, but not to the extent that the internal decision makers cannot access the information needed in a timely manner.

External Users

External users are any interested parties who must rely on the published financial statements and other publicly available information of an entity when making investment decisions. Some external users, such as lending institutions, may be in a position to demand additional information from an entity that is not publicly available. As mentioned earlier, the FASB defines external users as current and potential investors and creditors and their advisors who have a reasonable understanding of business and economics and who are willing to study the information with reasonable diligence. Investors, creditors, unions, analysts, financial advisors, competitors, and government agencies are all external users of information. Investors include individuals and other corporations. Creditors include lending institutions and suppliers of raw materials and other goods.

Needs of External Users

Creditors and investors comprise the two main sources of capital for publicly traded entities, so primary focus of financial statements is the needs of these two types of users. According to the FASB, financial reporting should provide information that

is useful to external users in making reasoned choices among alternative investment, credit, and similar decisions. Users cannot absorb infinite amounts of data, and too much information may obscure the most relevant measures of the success of a business. Therefore, the goal of accounting is to summarize the vast amount of information into understandable reports and disclosures. The FASB's statements are intended to require a minimum level of disclosure, but it is still up to each entity to make this information user friendly.

Needs of Investors and Creditors

Financial information must be relevant and reliable for it to be useful, and relevance means that it must also be presented in a timely fashion. Investors and lenders are interested in both a return *of* their investment and a return *on* their investment. They receive a return of their investment only if the organization can maintain its capital. They receive a return on their investment through dividends and interest. Investors in the stock market receive a return on their investment if the market perceives that the company is doing well. Actual or potential investors who have or are considering a direct ownership stake in an entity need financial information primarily to decide whether to initiate or continue this relationship (i.e., buy, hold, or sell the firm's securities).

Actual or potential creditors are interested in the ability of the entity to comply with debt covenants. The four decisions they are concerned with are to extend credit, maintain credit, deny credit, or revoke credit. Creditors are also interested in financial statements to determine the risk level of their loan. Lending institutions expect a higher return on investment for more risky endeavors and will make low-return investments only when the risk is similarly low. Therefore, the entity's credit rating is of particular importance. The credit rating is based primarily on the entity's liquidity, solvency, and financial flexibility, all of which are determined from the entity's financial statements and other disclosures.

Other users of financial statements include stock exchanges (for rule making, listings, and cancellations), unions (for negotiating wages), and analysts (for advising others).

Knowledge Check: Financial Statements

The next questions are intended to help you check your understanding and recall of the material presented in this topic. They do not represent the type of questions that appear on the CMA exam.

Directions: Answer each question in the space provided. Correct answers and section references appear after the knowledge check questions.

1. On the statement of cash flows, which of the following is included in the operating activities section?

- ☐ **a.** Purchase of equipment
- ☐ **b.** Purchase of treasury stock
- ☐ **c.** Issuing 1,000 shares of common stock
- ☐ **d.** Income taxes paid

2. On the balance sheet, which of the following accurately describes the order in which items are listed?

- ☐ **a.** Assets are listed from most to least liquid; liabilities are listed in the order in which they become due.
- ☐ **b.** Assets and liabilities are listed in the order in which they become due; equity is listed from least to most liquid.
- ☐ **c.** Assets are listed from least to most liquid; liabilities are listed in the order in which they become due.
- ☐ **d.** Assets and liabilities are listed from most to least liquid; equity is listed in the order in which the items are used.

3. True or false? The balance sheet does not show the value of the entity.

- ☐ **a.** True
- ☐ **b.** False

4. True or false? The income statement presents the following items net of tax: gains and losses from discontinued operations, and extraordinary items.

- ☐ **a.** True
- ☐ **b.** False

Knowledge Check Answers: Financial Statements

1. On the statement of cash flows, which of the following is included in the operating activities section? [**See *Statement of Cash Flows.***]

- ☐ **a.** Purchase of equipment
- ☐ **b.** Purchase of treasury stock
- ☐ **c.** Issuing 1,000 shares of common stock
- ☑ **d.** Income taxes paid

2. On the balance sheet, which of the following accurately describes the order in which items are listed? **[See *Balance Sheet.***]

- ☑ **a.** Assets are listed from most to least liquid; liabilities are listed in the order in which they become due.
- ☐ **b.** Assets and liabilities are listed in the order in which they become due; equity is listed from least to most liquid.
- ☐ **c.** Assets are listed from least to most liquid; liabilities are listed in the order in which they become due.
- ☐ **d.** Assets and liabilities are listed from most to least liquid; equity is listed in the order in which the items are used.

3. True or false? The balance sheet does not show the value of the entity. **[See *Balance Sheet.*]**

- ☑ **a.** True
- ☐ **b.** False

4. True or false? The income statement presents the following items net of tax: gains and losses from discontinued operations and extraordinary items. **[See *Income Statement.*]**

- ☑ **a.** True
- ☐ **b.** False